MAR - 8 1991

Thomas Hansen
Chicago Appeals AP:CHI

John Mack, Chief, Fin./Engrg. Services
National Office Appeals CC:AP:AS

[redacted]

This is in response to your request for valuation assistance dated February 5, 1990. Specifically, you requested a critique of [redacted] report concerning the valuation of the assets of [redacted]. We have reviewed the [redacted] report and associated workpapers, and the IRS Engineer's report. This critique confirms the telephone conference held earlier this year between yourself and Mr. John Huffman of this office.

Each of the asset types where there exists significant differences between the [redacted] report and the IRS Engineer report are discussed below.

Buildings - We agree with the IRS Engineer's use of the [redacted] workpapers for determining the level of obsolescence. [redacted] provides no basis for its use of alternative estimates of obsolescence in their report. However, we must disagree with the IRS Engineer's added obsolescence due to unique design. The facility was in use at the time and was expected to continue in use into the future. The unique design contributed to its continuing operation. Likewise, the differences in replacement costs could be partially explained by the additional engineering and design costs associated with unique structures and process engineering.

Equipment - We are unable to comment constructively on the methods applied except to note that the IRS Engineer's approach in general is correct.

Patents - The IRS Engineer's comments are correct concerning the growth rates claimed in the [redacted] report. However, we disagree with his assumptions of only a half year of [redacted] in the first year. He assumed [redacted]'s calculation was based upon calendar years, which it is not. We also note that [redacted] assumed that

08963

Thomas Hansen
Chicago Appeals AP:CHI

economic life is equivalent to legal life, which may or may not be the case.

Leases - We find the [redacted] leases valuation by [redacted] to be reasonable. But the valuation of the [redacted] leases would be properly determined with respect to the current market differential for [redacted], not the cost savings with respect to trucks. [redacted]'s workpapers indicate this would result in a valuation of about $[redacted] rather than the $[redacted] claimed.

Drawings - The taxpayer claims that it maintains a drafting department for refinements and alteration of its [redacted]. If these costs are separate from the engineering costs booked to the equipment, then the drawings have some value separate from the underlying equipment.

Secret Processes - The [redacted] report valued the secret processes using cost to reproduce less obsolescence. When comparing the values determined in relation to the revenues generated for associated products, the results are generally reasonable.

Supply Contracts - [redacted]'s report notes four supply contracts with favorable pricing compared to market prices. The proper method of valuing such arrangements is the present value as of the valuation date of the benefit to be derived. Each contract is discussed in turn. [redacted] - The below market price claimed was negotiated at about the valuation date and other consideration was noted in the agreement. Such a contract between arms-length parties would reflect the fair market value of the entire package as of the valuation date. No added benefit is created. The [redacted] contract, signed just 6 months prior to the valuation date, shows a [redacted] cent per pound pricing differential from current market ([redacted]% from contract price). If the product was in such short supply as [redacted] claims and the true pricing differential was so great, why didn't [redacted] cancel the agreement per the contract terms. The value claimed is suspect.

The [redacted] contract was valued based on the cost savings derived from the pricing of a finished intermediate product. Such savings would include, at the least, the overhead and return on the production of the intermediate product. This is an improper valuation of the contract. While some advantage may exist, [redacted] has not shown it. The [redacted] contract involved a

Thomas Hansen
Chicago Appeals AP:CHI

verbal extension to an existing arrangement, with a new contract signed some time after the valuation date. This does not create a favorable contract situation.

Summarizing this supply contracts discussion, the [redacted], [redacted] and [redacted] agreements have not been shown to have significant value. The [redacted] contract value is suspect.

GOODWILL and GOING CONCERN VALUE - [redacted] determined that no goodwill value exists by using the Capitalization of Excess Earnings approach. [redacted] also estimated the acquired going concern value at between $[redacted] - $[redacted] using three approaches- - percentage of purchase price, percentage of fixed assets, and present value of estimated opportunity costs lost in start-up. The taxpayer proposes to revalue the acquired assets, including going concern value, to the acquisition price using a second-tier allocation.

Neither the calculations for goodwill and going concern values, nor use of a second-tier allocation is properly applicable in this case. The purchase price was arrived at by arms-length negotiation. The seller, [redacted], was asking $[redacted]. The buyer, [redacted], prepared an internal report for its Board of Directors, concluding a bid price of between $[redacted] - $[redacted] for the equity. [redacted]'s analysis noted discussions with the investment bankers, [redacted], on likely competitive bids. The equity acquisition price of $[redacted] is the best estimate of its fair market value at the valuation date.

[redacted] argues that the purchase price exceeds the value of the acquisition. They attempt to justify this claim based upon unrealistically optimistic sales and earnings projections, and other then current acquisition price/earnings multiples([redacted] paid [redacted], while other comparable acquisitions paid [redacted]). These arguments are not persuasive. The price arrived at was between knowledgeable parties, neither under compulsion to buy or sell. [redacted] has not shown misrepresentation of the facts by the seller. Where the acquisition price is known, as are the values of tangible and other intangible assets, the proper approach to determine the fair market value of the goodwill and going concern value is the residual approach. See Banc One v. Commissioner, 84 TC 476 (1985); UFE, Inc. v. Commissioner, 92 TC 1314 (1989).

If you have any questions, please contact John Huffman at FTS 566-3292.